

As always, a key element in our GDP forecast is the consumer sector--the subject of chart 7. The upper left panel, presents the outlook for sales of light motor vehicles. Our projection, as well as those of many industry analysts, puts the "fundamental" demand for light vehicles--based on demographic and scrappage trends--at about 14-1/2 to 14-3/4 million units per year. Sales this year are likely to once again exceed the underlying trend, reflecting, in part, the strength of income and consumer sentiment. But sales are expected to move down toward the trend during 1998, and motor vehicles, therefore, have a slightly negative influence on GDP growth next year.

As noted in the Greenbook, we think that the current "pause" in consumer spending outside of the motor vehicle sector is just that--a pause, and not the beginning of a protracted slump. As I noted earlier, the monthly PCE data for May that we received yesterday came in stronger than expected and have led us to revise up our forecast of second-quarter consumer spending by about three-fourths of a percentage point. Moreover, as suggested by the forecast bar for 1997 in the upper right panel, consumer spending for goods and services other than motor vehicles is expected to continue rising at a fairly rapid clip during the next several months, bringing the four-quarter growth rate to more than 3-1/2 percent.

Our bullish near-term PCE forecast relies, in part, on consumer sentiment. As may be seen in the lower panels, both the overall Michigan sentiment index and the question on unemployment expectations, which is

not part of the aggregate index, suggest that consumers are extremely upbeat currently.

Returning to the upper right panel, consumer spending slows over the course of 1998 as the pace of hiring moderates and income growth tapers off. Spending may also be damped next year if lenders tighten credit terms and standards, as they've already been doing on a limited basis--especially for credit cards. Finally, there is the question of our stock market forecast and how we see it affecting consumer spending. That is the subject of your next chart.

Share prices have risen roughly 90 percent since the end of 1994, producing a substantial increase in price-earnings ratios. The p-e chart shown here updates the one Mike presented to you in February. After adjusting for special charges for restructuring, shown by the red line in the upper panel, the current p-e is at its highest level since the early seventies. The vertical lines denote troughs in the earnings cycle for S&P 500 stocks. You can see that peak p-e ratios typically have occurred near a trough in earnings. Well we're far from that: profits have been soaring in recent years. And yet, analysts expect even faster profit growth for the next three to five years--the middle left panel.

If, instead, profits flatten out as we are projecting, the analysts and other market participants will be disappointed. And, as I indicated earlier, in our forecast this--along with the updrift in interest rates--leads to a considerable price retreat next year.

In terms of our consumption forecast, the ups and downs of the stock market are expected to have a muted effect. The lower panel compares the wealth-income ratio (the blue line) with the consumption rate--that is, one hundred minus the saving rate. The chart suggests that consumption growth since early 1995 has been considerably less than would have been expected on the basis of this simple wealth-spending relationship. Of course, the opposite problem existed earlier in the nineties. Future revisions to the national income accounts could possibly alter this picture, but for now it's our assumption that in recent years other factors have been offsetting the influence of the wealth effect. Previous Greenbooks have discussed some of the possible explanations: strong income growth that has not yet been fully incorporated into perceptions of permanent income; increased debt-service burdens, especially among households with below-average incomes; and perhaps an increased desire to save for retirement, especially given the attention in the media to the problems of the social security and Medicare systems. In any event, our assumed stock market correction in 1998 reverses this year's sharp rise in the wealth-income ratio, which may begin cutting into spending by year end.

Your next chart examines the other key source of deceleration in GDP growth next year: a slowing of business spending for equipment. As may be seen in the upper panel, investment in producers' durable equipment this year is growing at an even more remarkable rate than the outsized pace recorded in 1996--fuel by continued rapid spending for computers, a surge

in aircraft deliveries, and a revival of outlays for other capital goods after a period of dormancy. However, all three components of PDE are expected to grow more slowly in 1998.

The middle left panel presents actual and expected unit shipments of PCs. The data are collected by the Information Technology Industry Council, a trade association representing the leading US PC and microprocessor manufacturers. As you can see, the industry expects shipments to cool a bit this year and next. Nevertheless, they still are forecasting gains of more than 15 percent per year. Recognizing the performance improvements in these boxes, unit PC sales underestimate by perhaps 10 percentage points or more the growth of real computer investment as reported in the national income accounts. If anything, then, our forecast of an 18-1/2 percent rise in real outlays next year may be on the low side.

Meanwhile, Boeing continues to ramp up its production. By the end of this year, Boeing expects to be completing 40 planes per month--about twice the pace recorded late last year. Under current schedules, the delivery rate levels off in 1998 and the impetus to GDP growth from this sector slackens.

Orders for nondefense capital goods other than computers and aircraft--the lower left panel--revived earlier this year and have remained near their record levels. This suggests strong investment in the next several

months. But investment demand is projected to soften thereafter as output decelerates and cash-flow flattens.

In contrast to the marked deceleration we are forecasting for equipment, the growth in outlays for nonresidential structures is expected to be maintained at close to the current rate. Contracts for private nonresidential buildings are at high levels; vacancy rates for office space have declined steadily; rents are rising; and REIT financing is readily available.

As shown in the upper panel of exhibit 10, the strong investment in computers has been associated with a pickup in the growth of the capital stock for information processing equipment. In addition, the growth of the stock of other kinds of business equipment--the middle panel--rose in the mid-1990s and has remained elevated compared with the 1980s and early nineties. Accordingly, the lower panel illustrates that the average growth of aggregate capital input for equipment and structures relative to the growth of labor--that is, capital deepening--has been running a bit faster in recent years than in the preceding decade. But this relatively small stepup is not enough, by itself, to significantly boost our assessment of trend productivity growth. And, as Dave Stockton will now discuss, we still see no compelling evidence that there has been an improvement in the growth of potential GDP recently.